Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Bailing Out Banks?

Congress is currently considering a bill that would authorize an $8.4 billion increase in U.S. contributions to the International Monetary Fund (IMF). President Reagan has requested the legislation on the ground that it is essential for averting an international financial crisis that might arise from large defaults on banking debts of the less-developed countries (LDCs). The bill has encountered considerable opposition because of a widespread suspicion that its real purpose is to bail out banks from their past lending excesses. Although it has passed the Senate, a different version with more stringent restrictions on future international bank lending is being considered by the House.

This *Letter* will examine four questions related to the proposed legislation: (1) Is it indeed for bailing out banks? (2) Should there be conditions attached to it for guarding against future lending excesses? (3) What would be its cost to U.S. taxpayers and its impact on U.S. financial markets? and (4) Why should we spend money to help foreign nations instead of our own economy?

Bank bail-out?

Like Damocles' sword, the threat of large LDC-debt defaults has hung over the international financial system since last summer. Particularly worrisome is the extent of U.S. banks' exposure to the threat. According to Federal Reserve data, U.S. banking claims on the LDCs amounted to $99 billion at mid-1982 and accounted for 149 percent of the total capital of all the banks that made significant (exceeding $20 million) international loans. For the nine largest banks, the total exposure amounted to 222 percent of their capital; their loans to Mexico, Brazil and Argentina accounted for 112 percent. Large exposure to LDCs are also common among all the major banks outside the United States. Thus, any large LDC-debt defaults could seriously disrupt the U.S. and world banking systems.

What has led to the current condition? Broadly speaking, there are two schools of thought on this subject. One might be called the "solvency school," and the other the "liquidity school." The former maintains that the current distress is a result of excessive borrowing by the LDCs abetted by banks' competition for loans. From this viewpoint, the borrowing countries are not unlike households or firms that have over-extended themselves and are thus in a state of "insolvency." The liquidity school, on the other hand, emphasizes the temporary nature of the borrowing countries' current payment difficulties, stressing that they arose from special factors during the last three years: the prolonged world recession, unprecedentedly high interest rates,and banks' reluctance to roll over credits. From this viewpoint, the present difficulties are symptomatic of a "liquidity crisis" that arose from a particularly severe world recession.

The truth may lie between these two polar views. But wherever it lies, to try to pin blame and fix responsibility now is perhaps futile and pointless. When fighting a fire, one cannot wait for a determination of its cause before deciding on a strategy for putting it out. Fortunately for international lending problems, a strategy has already been developed and, thus far, successfully implemented.

The strategy has five elements. First and foremost, the commercial banks have been induced, cajoled, or pressured to continue lending to the hard-pressed debtor countries. From their individual viewpoints, it may not seem prudent to renew credits to risky borrowers, and many banks have not renewed loans. However, what might appear to be individual prudence is collective folly, for a failure to renew loans is precisely what would precipitate a financial crisis. Second, in order to convince bankers that they are not being asked to pour good money after bad, public international finan-

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cial agencies, such as the IMF, must take up the slack in financing. To do the job, the IMF must have sufficient resources. The Administration's request is but the U.S. share in a proposed $43 billion increase in IMF resources.

Third, as a part of IMF loan conditions, the debtor countries must adopt and carry out adjustment programs designed to reduce their payments deficits. Fourth, since the IMF loan packages take time to negotiate, national governments and the Bank for International Settlements have provided large emergency credits to debtor nations to tide them over in the interim. Fifth, because ultimately the debtor nations' abilities to pay depend on a worldwide economic recovery, the industrial nations have agreed to pursue economic policies that promote a strong and sustainable recovery.

Thus, the proposed bill for authorizing an increase in IMF resources is not a bail-out of banks—the banks are being asked to continue lending—but an essential element in the current strategy for safeguarding the soundness of the international financial system. As the world learned from the experience of the 1930s, a collapse of the world financial system would have disastrous effects on the world economy, including our own.

Restrictions on future lending?

Under public pressure, Congress is attaching conditions to the proposed bill intended to avert future recurrences of "excessive" lending. The version that has passed the Senate is less stringent than that being considered by the House. The latter requires, among other provisions, that banks set aside loan-loss reserves on foreign lending *in anticipation* of potential repayment difficulties. The total effect of the proposed restrictions would be to make it more costly and cumbersome for banks to make foreign loans.

These proposed restrictions stem from a valid concern over the riskiness of foreign lending. In addition to credit risk, foreign lending entails a "country risk" in that an ordinarily sound loan may turn sour because of unforeseen balance-of-payments difficulties or political upheavals in the borrowing country. This concern justifies extra caution in assessing foreign lending risks, but it does not warrant government restrictions on foreign lending. After all, risk-taking is the essence of the free-enterprise system, and it is doubtful that the system would be well served by legislation that limits risk-taking. Furthermore, there is little evidence that government agencies are any wiser than market participants in assessing risk.

Another legitimate concern is the long run advisability of relying on banks to finance world payment imbalances, thereby incurring the risk of recurrent crises in the international financial system. However, this is a long-run problem. Until a safer avenue is found, there is no alternative but to follow the same road and deal with crises as they arise. In the meantime, the current strategy calls for banks not to reduce lending to the hard-pressed debtor nations. To restrict foreign lending at this juncture would be like cutting the water supply to fire fighters in the midst of a dangerous conflagration.

Budget cost and market impact

The fund request comes at a time when Congress is under pressure to trim government spending to reduce the budget deficit. Would approval of the $8.4 billion bill not increase the budget deficit?

Surprisingly, the answer is no. What happens after the bill is passed is that the Treasury would extend a standby credit to the IMF; no funds would need to be made available until actual drawings occur. Upon a drawing, the Treasury would raise funds from the market by issuing securities. The fund transfer to the IMF would be a budget outlay, but unlike other budget outlays, it would be balanced by an increase of the same amount in the Treasury's reserve position at the IMF. This reserve is an international liquid asset available to the United States to draw upon, without interest and without strings attached, to finance U.S. payments deficits. In fact, over the past 19 years, the United States has drawn on the IMF some 24 times and, with a cumulative total drawing of $6.5 billion, is the second largest user (after the United Kingdom) of IMF funds. Thus, borrowing from the market and transferring the proceeds to the IMF is not unlike a household borrowing from an uncle and placing the funds in a bank account. In no sense can it be interpreted as resulting in an increase in the budget deficit—either for a household or for government.

Some might argue that even though the analysis may be valid in budget accounting, it nevertheless makes little economic sense because the fund transfer implies that purchasing power would be taken from the market and transferred to the debtor nations through the IMF. This action presumably would "crowd out" other market borrowers just as other types of Treasury borrowing for financing government spending would do.

This argument, though seemingly persuasive, fails to carry the analysis through to the end. It can be shown that, unlike other types of budget outlays, fund transfers through the IMF to the debtor nations would raise U.S. interest rates and crowd out U.S. domestic spending only under certain circumstances. There are only two types of cases to consider: one may be called "pure financial transfers" and the other, "real transfers." The former arises if the debtor nations used IMF funds to repay U.S. banks, thus restoring the funds to the U.S. financial market. If the repayment were made to non-U.S. banks, the same would result if the latter invested the funds by purchasing U.S. securities. In either case, there would be no effect on U.S. interest rates, no crowding-out, and zero impact on the real economy.

Real transfers would arise only if the debtor nations used the funds to increase their net imports from the United States and not to repay debts, or to repay debts to non-U.S. banks and the latter transferred the funds to bank customers for them to purchase goods and services in the United States. In either case, the funds would not be restored to the U.S. financial market, U.S. interest rates would rise, and some U.S. expenditures would be crowded out. Indeed, the rise in interest rates would be the market mechanism for making the resource transfers to foreign nations.

In short, the Treasury financing would result in a rise in U.S. interest rates only if the funds were used to finance a rise in U.S. exports. Since under the present circumstances the IMF loans would be used almost entirely for helping the LDCs repay their existing debts (nearly 40 percent of which is owed to U.S. banks), any "real transfer" effect would likely be small relative to the total size of the U.S. financial market of more than $400 billion net borrowing a year by domestic non-financial sectors.

Foreign aid?

Lastly, the question of whether the proposed bill aids foreign nations or ourselves can be answered quite simply: it aids both. As stated, the proposed bill is an essential element in the existing strategy to ensure the stability of the world financial system, one in which the U.S. national interest is clearly at stake.

A concrete case may help illustrate the point. Mexico is our third largest trade partner, after Canada and Japan. In 1982, because of its external debt problem, it cut its imports back drastically. As a result, our exports to Mexico fell by a staggering 60 percent, and our $4 billion trade surplus with Mexico in 1981 turned into a $4 billion deficit in 1982. Based on an estimate that every $1 billion increase in U.S. exports creates 24,000 new jobs in the U.S. economy, the Mexican debt problem alone appears to have cost the U.S. 200,000 jobs in 1982. Clearly, in this case, any aid to help Mexico service its external debts will not only help promote world financial stability, but will also benefit the U.S. economy.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/13/83	Change from 7/6/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	162,235	– 878	1,562	1.0
Loans (gross, adjusted) — total#	140,788	– 888	891	0.6
Commercial and industrial	43,932	– 329	36	0.1
Real estate	56,124	61	– 1,276	– 2.2
Loans to individuals	23,944	25	594	2.5
Securities loans	2,504	– 108	261	11.7
U.S. Treasury securities*	8,392	17	1,765	26.6
Other securities*	13,053	– 7	– 1,094	– 7.7
Demand deposits — total#	41,937	–4,048	2,091	5.2
Demand deposits — adjusted	30,527	490	2,294	8.1
Savings deposits — total†	66,794	– 474	36,052	117.3
Time deposits — total#	65,523	– 225	– 32,200	– 33.0
Individuals, part. & corp.	59,786	198	– 28,437	– 32.2
(Large negotiable CD's)	18,912	– 234	– 17,524	– 48.1

Weekly Averages of Daily Figures	Week ended 7/13/83	Week ended 7/6/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	122	141	56
Borrowings	163	807	10
Net free reserves (+)/Net borrowed(–)	– 42	– 666	46

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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